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Why traditional equity portfolio risk measures fail long-term investors

The Way Forward
a.k.a.
Standing for Real Action

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"To quote my broker, 'Past results are no guarantee of future performance'."

This communication is not a securities recommendation.

Any person considering action on the basis of this communication must seek individual advice relevant to their particular circumstances and investment objectives.

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Traditional equity portfolio risk measurement fails long-term investors

Modern Portfolio Theory fails long-term investors by:

- Assuming risk is symmetrical when it is one sided
- Ignoring agency issues
- Focusing on the short-term
- Being pre-occupied with quant
- Overlooking the quality of the underlying businesses
- Being based on unrealistic assumptions
- Encouraging diversification as a substitute for due diligence
- Promoting relative returns versus absolute outcomes for clients

Thereby resulting in incorrect risk assessments and sub-optimal returns for investors

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"It sounds a little too perfect. What's the downside?"

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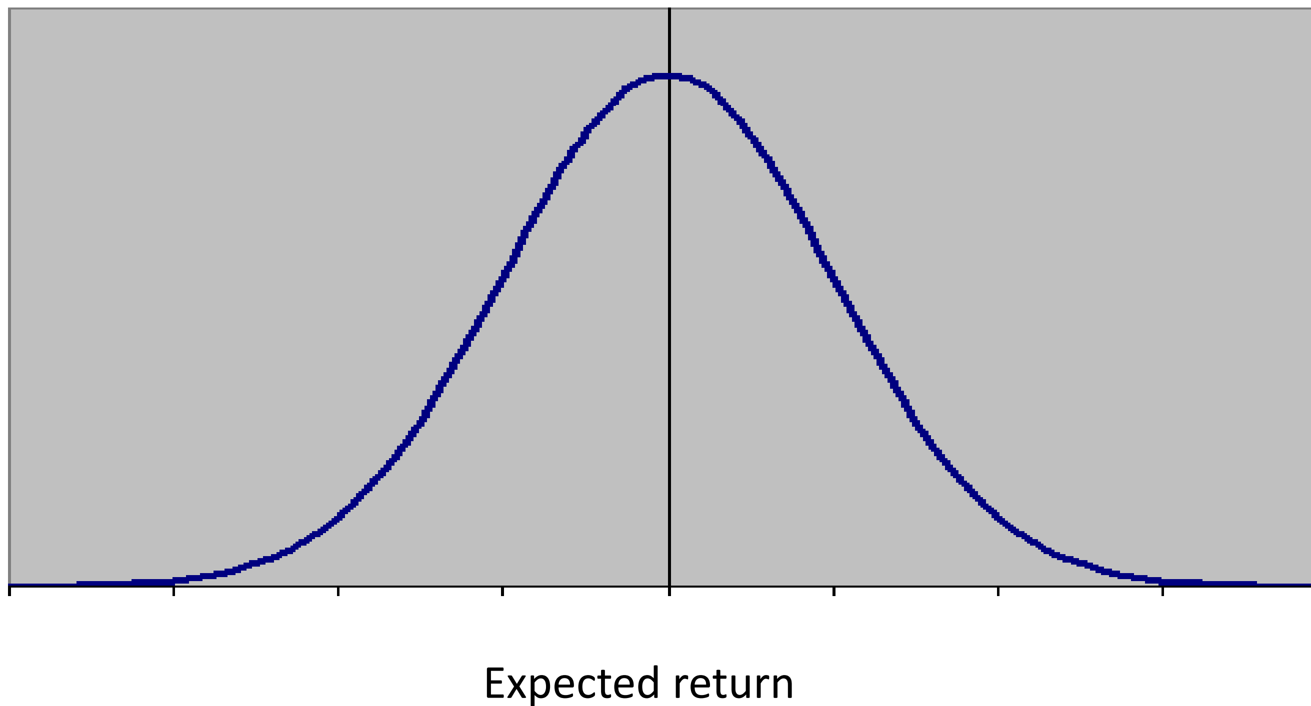
Failure 1. Assuming risk is symmetrical when it is really one sided



Risk is the component of the uncertainty of future events relating specifically to the probability of an adverse outcome

"I'd rather be a huge part of the problem than a tiny part of the solution."

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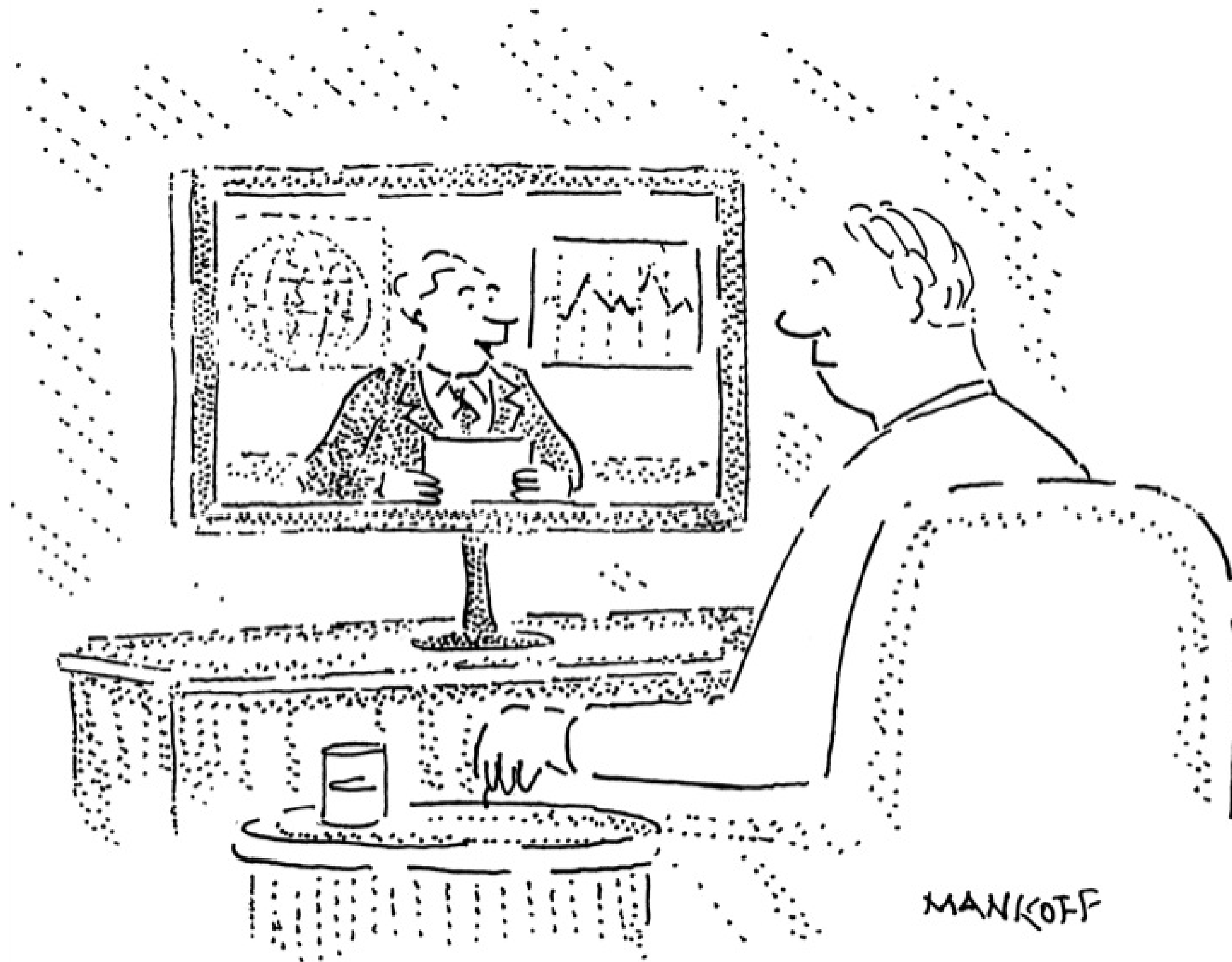
Failure 2. Agency Risk

- Investment risk versus business risk - Agency issues create a disconnect between the alignment of investors and fund managers

- Investors wish to maximise returns… many managers want to do this and maximise their FUM. These objectives are mostly incompatible



"On Wall Street today, the stock market corrected its previous correction, and is pretty sure it's got it right this time."

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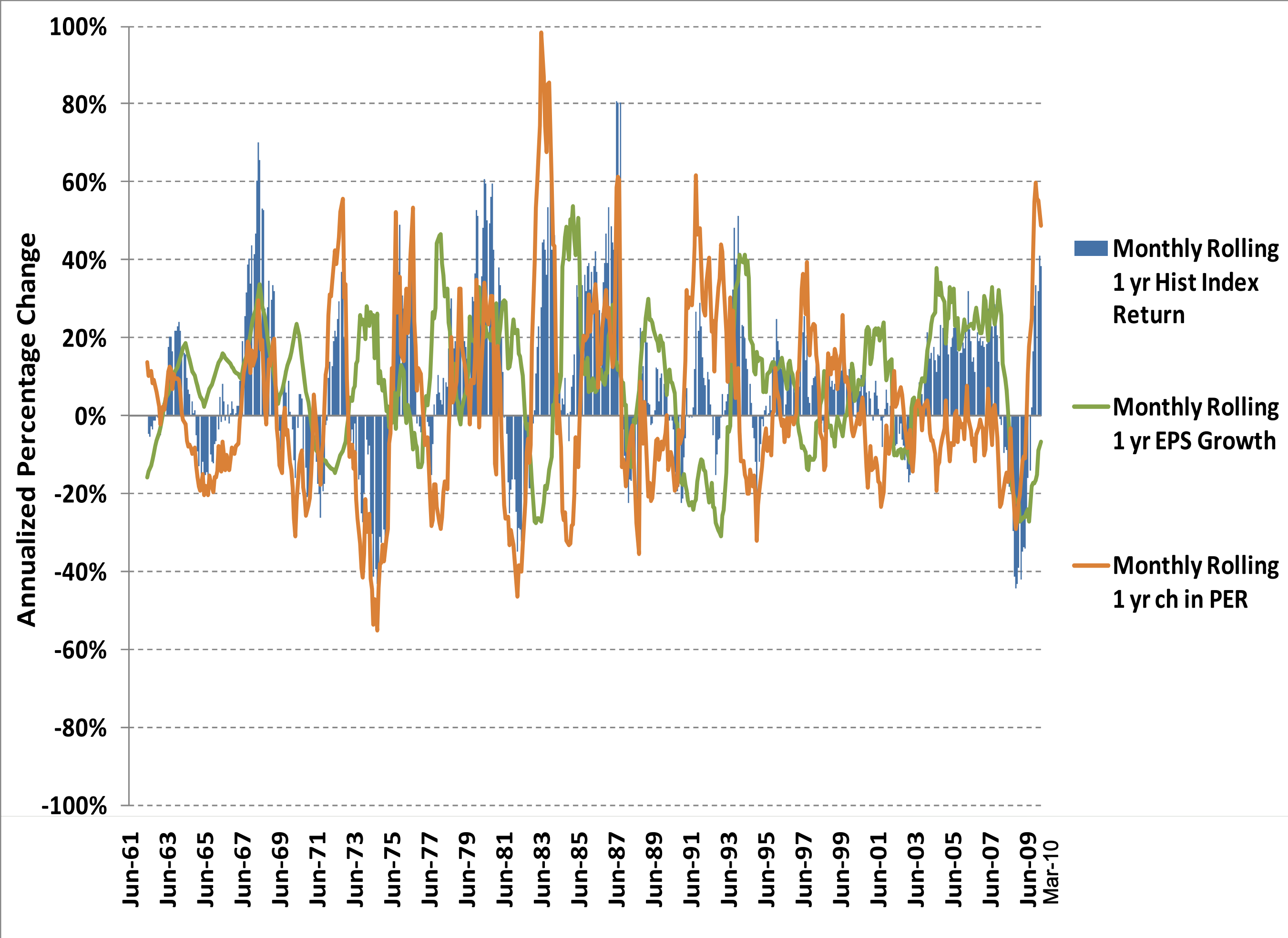
Failure 3. Short-term focus

- MPT is based on measures of short-term volatility and it can be proven to detract from long-term returns
  - There is empirical evidence that short-term share price movements are driven by factors other than intrinsic value
  - Monthly returns are much more volatile than 5 or 10 year returns and are more often negative than returns measured over the longer term

Rolling Returns, P/E Ratio and EPS Growth for 1 Year



Source: Credit Suisse, Goldman Sachs, DataStream, Hyperion Asset Management

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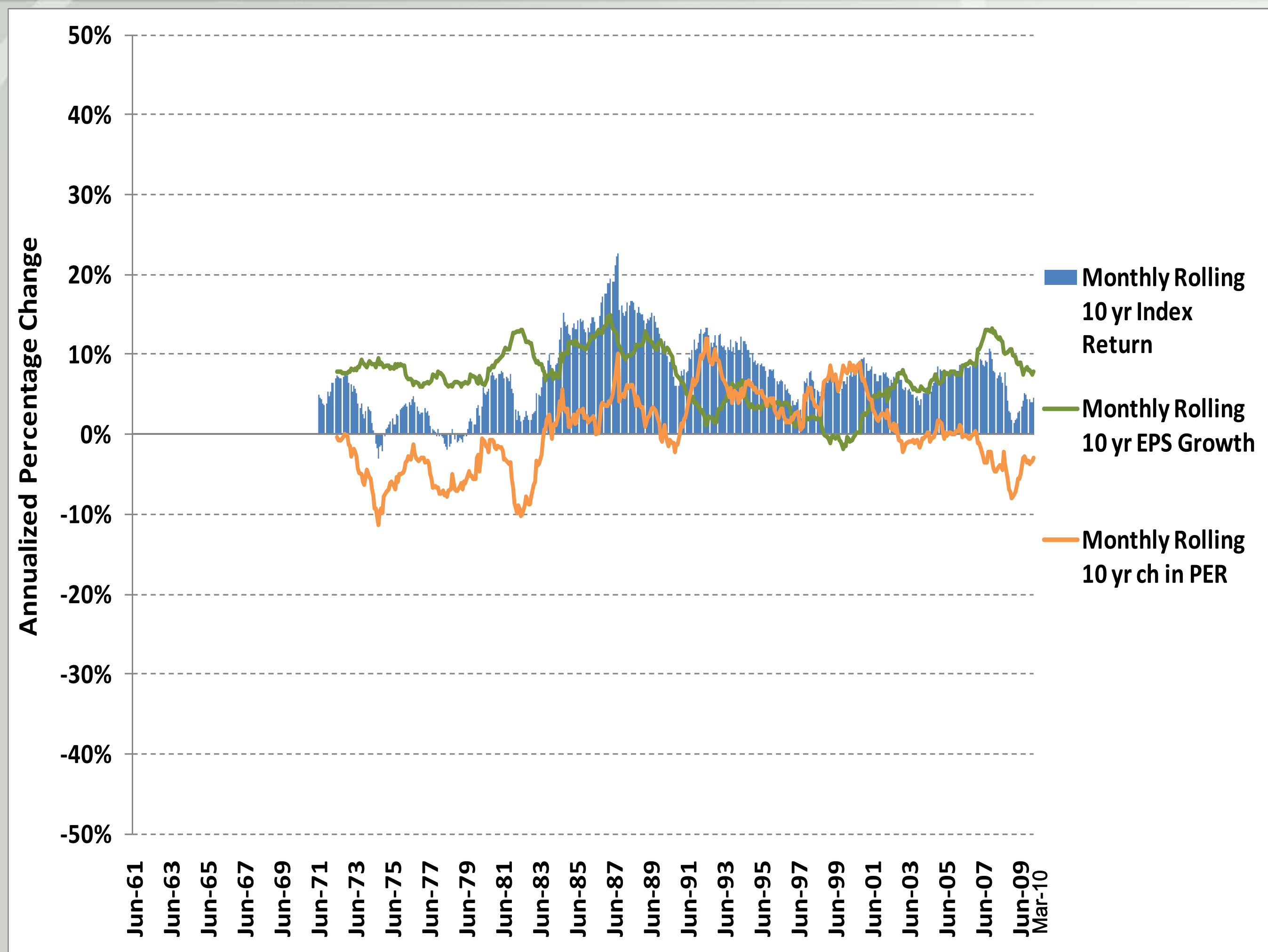
Rolling Returns, P/E Ratio and EPS Growth for 10 Years



Source: Credit Suisse, Goldman Sachs, DataStream, Hyperion Asset Management

"Here are some of my investment assumptions. Find something to base them on."

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Failure 4. Pre-occupation with quant as the source of truth

CEO comment of the day

”...be sceptical of history-based models. Constructed by a nerdy-sounding priesthood using esoteric terms... these models tend to look impressive... Beware of geeks bearing formulas.”

Warren Buffett
CEO
Berkshire Hathaway

"Can a rising tide lift a boat that has a huge hole in the bottom?"

Failure 5. MPT overlooks the low quality of the underlying businesses in an index

- MPT is preoccupied with indices as the basic denominator of risk...

  A stock's index weight is unrelated to its long-term return outlook

- Strong evidence exists that low quality/ high risk stocks produce lower returns over the long-term

- An index may comprise low quality stocks

Failure 6. MPT incorporates unrealistic assumptions

- The assumptions:
  - Expected returns are normally distributed
  - Investors are rational
  - Risk is the variability of expected returns

- MPT does not distinguish between risk and uncertainty

- Real world outcome is very different – the real risk is the short-fall risk not the variability risk

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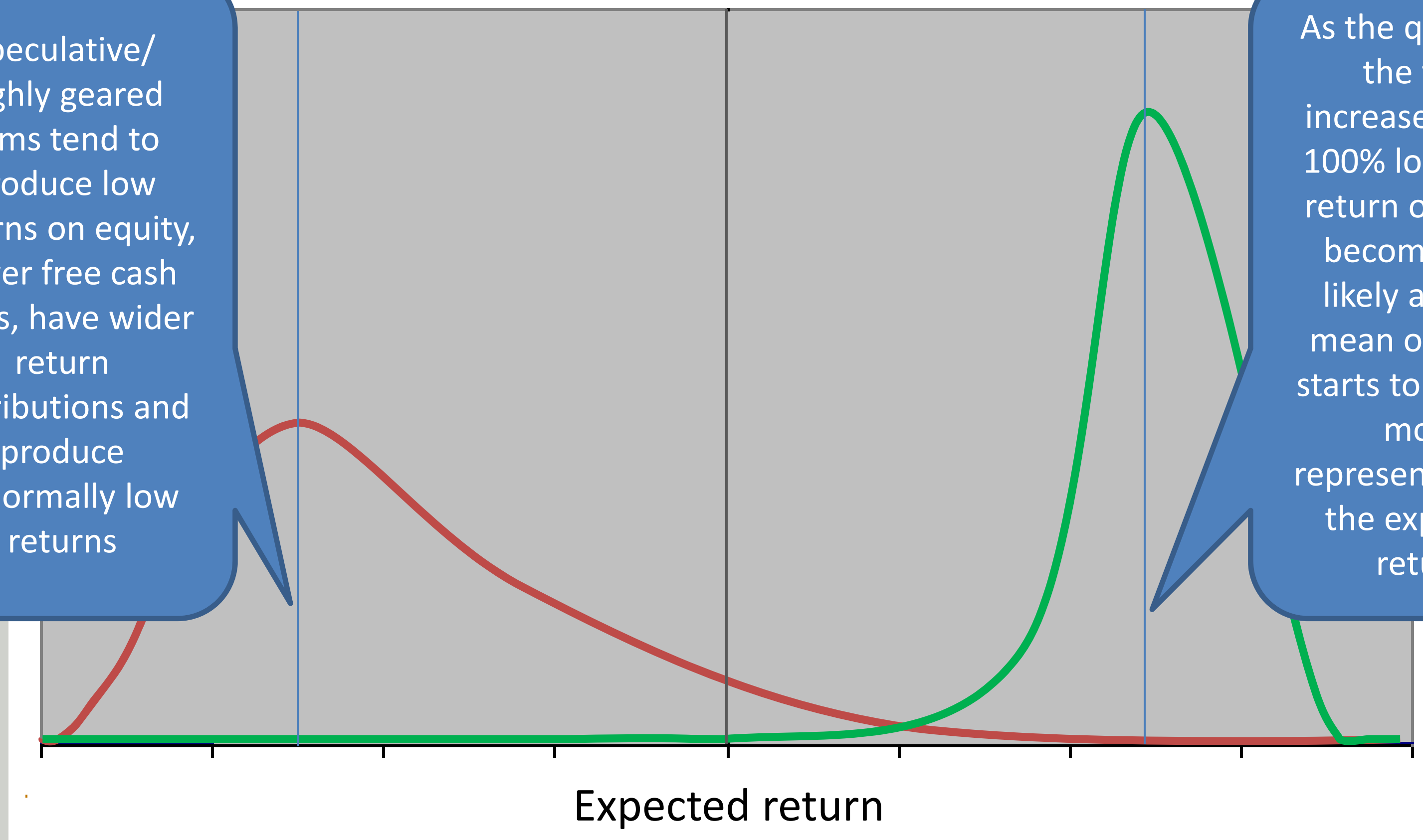
MPT may assume returns are normally distributed but evidence indicates otherwise



Area under the green and red lines is the same

"I was spreading some risk around, and apparently it all wound up in your portfolio."

Failure 7. Diversification has been substituted for due diligence

- Diversification has been seen as the safety net and ignores the quality of the underlying businesses in the portfolio
- High quality businesses:
  - provide less risk of bad return outcomes
  - are less likely to go bankrupt
  - are less likely to suffer permanent declines in free cash flow
  - have better opportunities to grow their earnings with lower fundamental risk

"Something is definitely going on. We're back to eating dog food."

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Failure 8. Relative short-term returns to investors are promoted ahead of long-term outcomes

- Clients perceive risk as absolute not relative….

  Cash is the benchmark in a bear market however it's about long-term capital preservation and growth and matching the investment horizon to the investment objectives

- Volatility is mean reverting and cyclical over the longer term and therefore of diminished importance

Risk management tools for portfolio construction in the real world

- Longer term focus in order to match investors' time horizons
- Insensitivity to indices – use indices correctly as benchmarks over the longer term and not as the basis for portfolio construction
- Due diligence on business quality rather than unquestioning reliance on diversification so as to understand and manage shortfall risk

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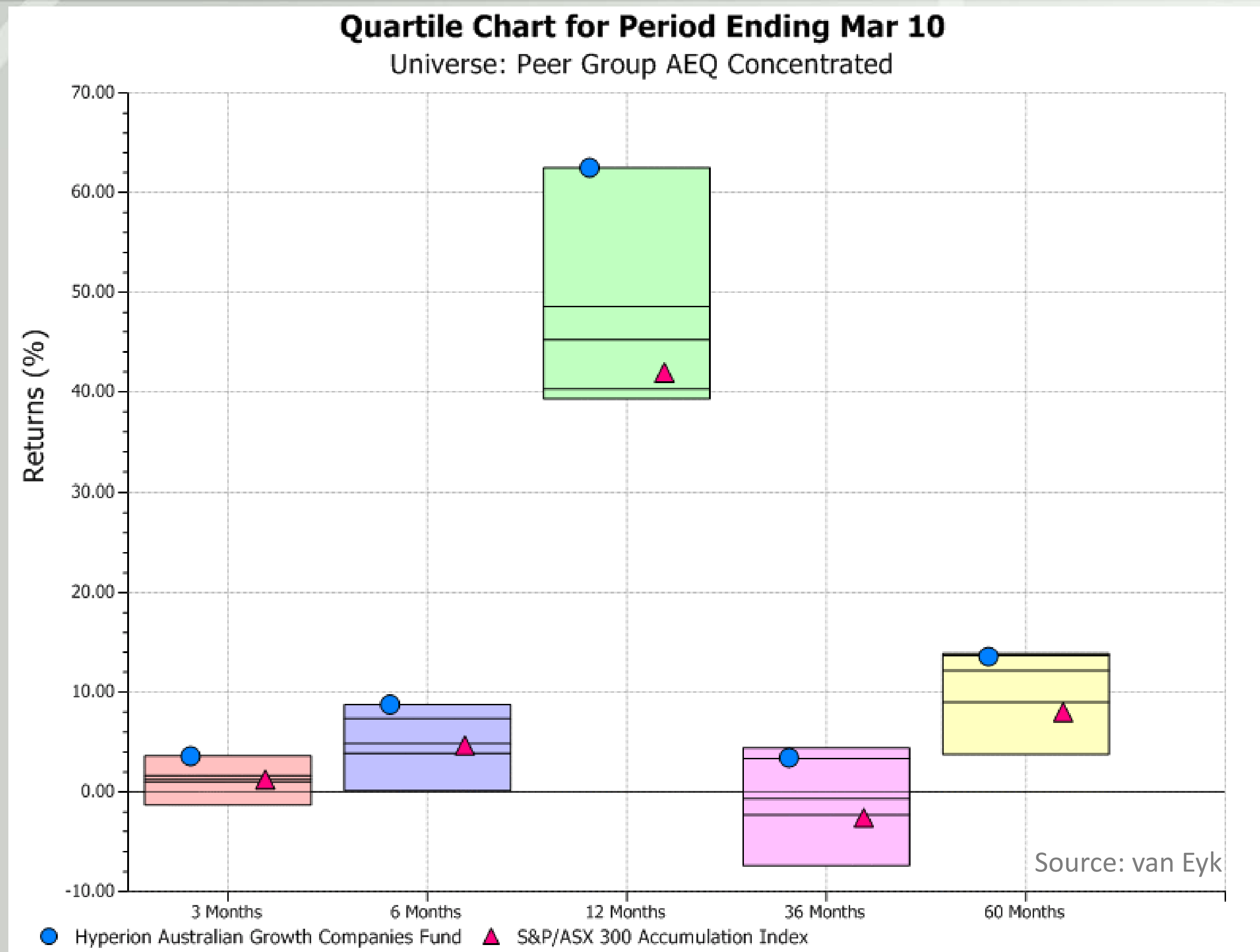
Hyperion is a manager that produces long-term results



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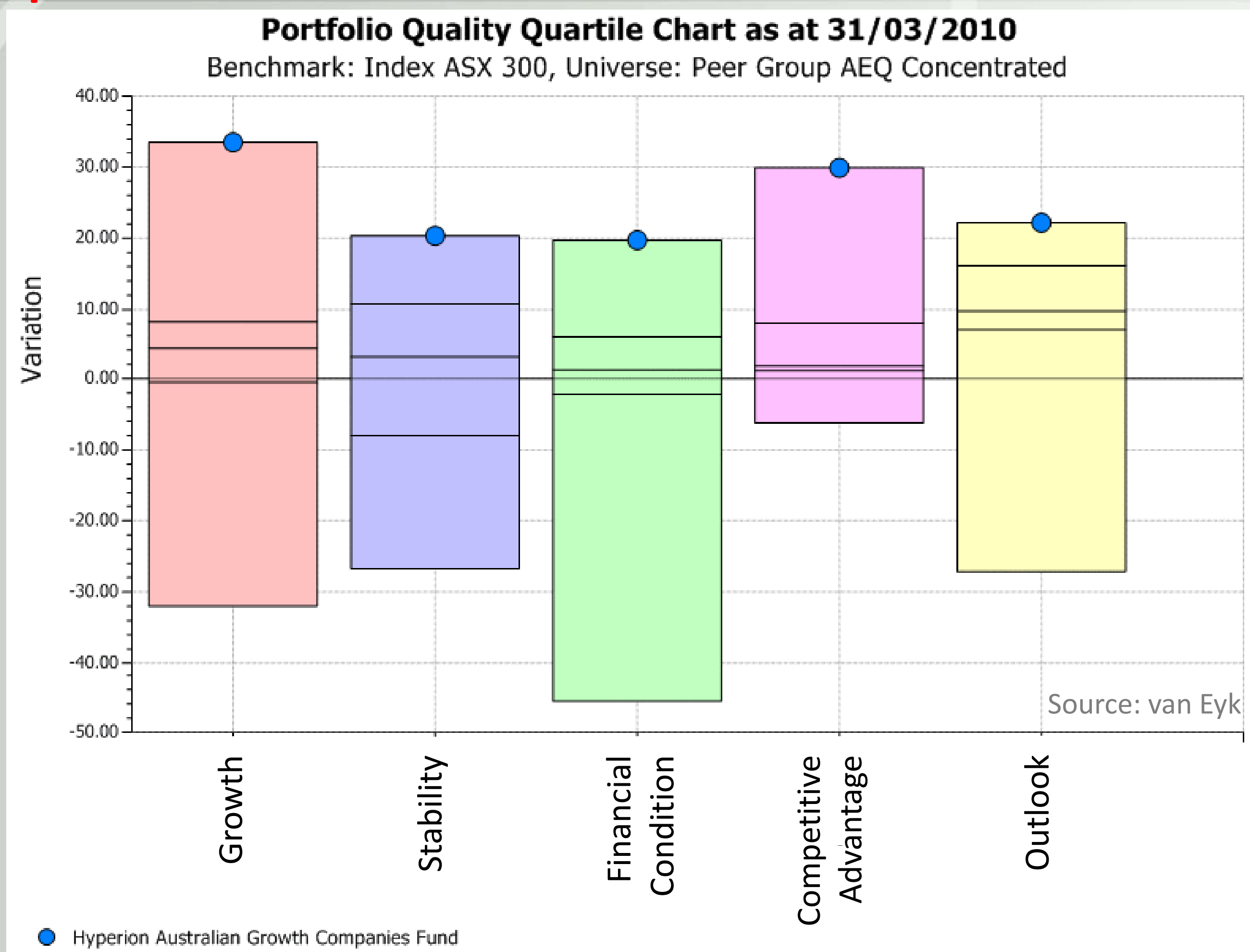
... and executes quality investing with absolute discipline



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Products, Platforms, Ratings and Blending

★ Focused on quality ★ Same team for 14 years

★ Fully aligned – we eat our own cooking

Products: portfolios of approx 22 quality stocks

- Hyperion Australian Growth Companies Fund
- Hyperion Small Growth Companies Fund

Platforms:

- BT WRAP
- Colonial First Wrap
- Macquarie Wrap
- NetWealth

Ratings:

- Lonsec – Recommended
- van Eyk – A
- Standard & Poors – Four Stars
- Morningstar – Recommended
- Zenith - Recommended

Blending:

Blend with an index fund or deep value manager

Distribution:

Pinnacle Investment Management

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